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TO RUEHC/SECSTATE WASHDC 7443
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INFO RUCPDOG/USDOC WASHDC
RUEHBK/AMEMBASSY BANGKOK 3889
RUEHBJ/AMEMBASSY BEIJING 7468
RUEHUL/AMEMBASSY SEOUL 9060
RUEHGP/AMEMBASSY SINGAPORE 7061
RUEHKO/AMEMBASSY TOKYO 9269
RUEHML/AMEMBASSY MANILA 0197
RUEHJA/AMEMBASSY JAKARTA 4145
RUEHKL/AMEMBASSY KUALA LUMPUR 3827
RUEHHI/AMEMBASSY HANOI 3404
RUEHBY/AMEMBASSY CANBERRA 4646
RUEHWL/AMEMBASSY WELLINGTON 1912
RUEHHK/AMCONSUL HONG KONG 8757
RUEHGH/AMCONSUL SHANGHAI 1491
RUEHGZ/AMCONSUL GUANGZHOU 0675

UNCLAS SECTION 01 OF 03 TAIPEI 002525

SIPDIS

SENSITIVE
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STATE PLEASE PASS USTR
STATE FOR EAP/RSP/TC, EAP/EP
USTR FOR KATZ AND STRATFORD
USDOC FOR 3132/USFCS/OIO/EAP
TREASURY FOR OASIA/TTYANG AND HAARSAGER
TREASURY ALSO PASS TO FEDERAL RESERVE/BOARD OF
GOVERNORS, SAN FRANCISCO FRB/TERESA CURRAN, AND NEW YORK FRB MARI
BOLIS

E.O. 12958: N/A

TAGS: [EINV](#) [EFIN](#) [ECON](#) [PINR](#) [TW](#)

SUBJECT: Taiwan Banks - Too Much Money but Low Profits

Summary

1. (SBU) Summary. Taiwan's banking system is stable but anemic, financial analysts and local U.S. bank representatives told officials from the San Francisco Federal Reserve Bank. The banking sector faces low profitability and too much competition. Taiwan's large banks have excess liquidity due to a high savings rate and low domestic investment. They are largely unable to follow corporate customers overseas, namely to China. Local banks have high hopes of developing a potentially lucrative asset management business, but today much of Taiwan's savings and investments are flowing out of Taiwan, chasing higher returns and perhaps avoiding tax. Although regulators have begun financial sector reforms, progress is too slow and state-owned or state-controlled banks still hold over half of Taiwan's banking assets. Little will change before the presidential election in March. End Summary.

2. (SBU) Federal Reserve Bank of San Francisco Senior Vice President Stephen M. Hoffman, Jr. and Senior Manager Walter Yao visited Taiwan November 7-8 and met with a variety of local representatives of U.S. banks as well as local financial analysts who provided their assessments of Taiwan's financial sector and its regulatory and supervisory framework.

Taiwan Financial System - Stable Medium-Term Outlook

3. (SBU) Analysts at Taiwan Ratings, the local partner of Standard & Poor's, place Taiwan at level 4 "moderate risk" on a scale of 1 to 10, with one being the most stable. They highlight the key risk as profitability, which last year was "close to zero," with a 0.2% to 0.3% return-on-assets. This is low in absolute terms, and weak compared to the rest of the region. Taiwan Ratings, along with

other analysts, noted that this poor performance was in part due to too many banks and stagnant demand for loans. Although much of corporate Taiwan has relocated manufacturing operations out of Taiwan, particularly to China, Taiwan banks cannot follow them there. Domestic demand is still sluggish. One equity analyst called Taiwan's financial sector "the worst-performing in the region - bar none."

¶4. (SBU) Taiwan's high savings rate, currently 26% of income, means that banks are awash in deposits, creating excess liquidity. This excess liquidity in turn drives down interest rates, which then triggers capital outflow as depositors chase higher returns elsewhere. But competition in Taiwan is fierce. There are 41 banks competing for business, and over half of Taiwan's banking market share is held by state-owned or state-controlled banks. This leads to intense competition which erodes margins. It can also lead to other problems. Taiwan Ratings highlighted the credit card crisis that appeared in late 2005. With excess deposits, banks looked for high-margin products and began heavily promoting credit cards. Over-competition led to a loss of underwriting discipline and banks wound up holding substantial amounts of sub-prime consumer loans, many of which had to be written off.

Regulators Slow, but on the Right Track

¶5. (SBU) Taiwan Ratings largely praised the efforts of Taiwan regulators to stabilize the banking system and to advance financial reforms. They lamented, however, that many of their actions seemed driven by political considerations. They cited the instance of Bowa Bank, which eventually was taken over by the authorities. Taiwan Ratings claimed that the authorities, rather than acting quickly when the bank's problems became apparent, instead directed a state-owned bank to prop it up with interim deposits. This simply

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prolonged and worsened the problem. They also criticized the regulators as not being transparent enough and not moving fast enough on financial reforms. Other analysts echoed these concerns.

¶6. (SBU) Two major goals of Taiwan's financial sector reform are to reduce the number of banks and to decrease the percentage of bank assets held by state-owned or state-controlled banks. After industry consolidation, regulators want to wind up with three to five "national champions," local banks each with over 10% market share. Although the number of banks has already been reduced from 41 to 56, most of the consolidation has involved small banks, and no single bank holds 10% market share. Efforts to divest state-owned banks have been hampered by strong unions and political considerations.

¶7. (SBU) Politics divided the analysts. Many called the current DPP government inexperienced in financial management and noted that staff in key leadership positions changed constantly. Others, however, praised the regulators as "on the right track," although lamenting that they needed to move faster. Our most hopeful interlocutor stated that although the DPP got a rough start, it has finally assembled a good financial regulatory team that knows what it needs to do. Political considerations, however, were likely to slow its work. All agreed that not much would happen before the March presidential election.

Local Reps of U.S. Firms Agree

¶8. (SBU) Local representatives of U.S. banks echoed many of the analysts' views. Not only did they think the pace of reform should be faster, they expressed concern about what they called "ad hoc regulation" and complained that policies and rules were not always clear. U.S. bankers also worried that regulators were not independent enough. They also argued that regulators needed to make reporting requirements less burdensome. At the same time, however, they noted that Taiwan regulators, unlike many others in the region, are friendly to foreign banks and encourage them to buy distressed local banks and enter the market. Six banks have already been purchased by foreign institutions or private equity firms.

¶9. (SBU) U.S. bankers note that international banks are in a very strong position to be competitive in Taiwan. They will have access to Taiwan customers and can service them most anywhere in the world, including China, offer global asset management services, and operate with international best practices. Foreign banks are already tough competitors in Taiwan. Citibank, for example, is a major player in Taiwan retail banking and generates more profits with 11 branches and 3,000 employees than local competitors with over 150 branches, according to one U.S. banker.

Do Taiwan Banks Have a Future?

¶10. (SBU) With competition from the state-controlled banks and no way to lend to Taiwan firms in China, how will Taiwan banks grow? Analysts note that although Taiwan banks are still locked out of China, they are making headway in Vietnam, although it will be probably two to three years before this expansion positively affects their bottom line. Most believe that China will eventually open up, but in China they will have to compete with low-cost local players as well as some of the world's most accomplished international banks. Local analysts see opportunity in China over the long term, but U.S. bank representatives in Taiwan caution that it won't be easy. Their strong point will be their knowledge of their Taiwan customers. One analyst noted that Taiwan banks are trying to reach out to Taiwan customers in China via branches in Hong Kong, but like

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their parent banks, these branches hold deposits far in excess of their loan portfolios.

¶11. (SBU) Most analysts see the best opportunities for Taiwan banks in fixing things at home and turning more attention to asset management. Taiwan households hold about US\$1.3 trillion in assets, of which 41% is cash. Combine this with an aging population and a new government-mandated pension plan, Taiwan has a real need for wealth-management services. Excess liquidity has driven down interest rates and has led to capital outflows as Taiwan people chase higher returns elsewhere. Comparatively high tax rates also keep money out of the country. "It is quite sad," remarked Sophia Chen, head of Research at Merrill Lynch, "that Taiwan money has been helping private banks in Hong Kong and Singapore" build their wealth management business.

¶12. (SBU) Chen forecasts that by making a few changes, the Taiwan authorities can give a big push to developing Taiwan's wealth management business. First she suggests cutting the inheritance tax, which at its current maximum rate of 50% compares unfavorably to zero in Hong Kong and 5-10% in Singapore. Unlike cutting individual and corporate income tax rates, which would have a larger impact on government revenues, inheritance tax does not generate near as much revenue. It would also encourage households to keep more of their assets in Taiwan. Tax avoidance, she said, is one of the main reasons Taiwan investors choose to take their assets offshore.

¶13. (SBU) It is also possible that there will be a pick-up in corporate loan activity in Taiwan. One analyst argues that as costs quickly rise in China, Taiwan becomes a more attractive manufacturing location, particularly if Taiwan authorities lower corporate tax rates and streamline some investment procedures such as acquisition of land. The cap on China investments at 40% of a company's net worth also limits the amount of funds that firms want to bring into Taiwan.

Comment

¶14. (SBU) Comment: Virtually all of the analysts and U.S. bankers told the same story: Taiwan's financial system is stable and its regulators are on the right track, but further financial reform is needed to strengthen Taiwan banks. Unless Taiwan's regulators pick up the pace, however, Taiwan clients are likely to be sending more of their business overseas. End Comment.

¶15. (SBU) This cable has been cleared by Walter Yao, Senior Manager, Country Analysis Unit, Federal Reserve Bank of San Francisco.

